RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

Oct. 19, 1988 **LETTER 1002**

Oct. 7 DJIA 2150.25; PTI 2786; A-D Ratio -10.14
Oct. 14 DJIA 2133.18; PTI 2784; A-D Ratio -10.56
Current Dow Yield: 3.61%; Dow P/E: 12.7
Dow 200-day mov aver: 2040; DowPow: 853
Percentage of undervalued blue-chips: 21%

THE PICTURE: This Letter is a bit unusual in that I have taken up a large part of it with a discussion of Dow Theory and its implications for today's market. It's extremely important that you understand the basic tenets of Dow Theory. Therefore I urge subscribers to save this Letter for your files or at least read it over several times and fix the Dow Theory concepts firmly in your mind.

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The stock market has acted pretty much in accordance with the picture outlined in the last Letter. On October 10 (Columbus Day) the Dow rallied to a post-crash recovery high of 2158.96, thereby confirming the previous recovery high recorded by the Transportation Average. Interestingly, the new Dow high was a mere 0.35 above the 2158.61 Dow high recorded on July 5.

The Dow recovery high was not, sad to say, an event to be celebrated. The reasons are three-fold: first, the upside confirmation occurred during the first phase of a primary bear market. Therefore, Dow Theorists do not accept it as "a bull market signal." Second (as outlined in the last Letter), the October 10 new Dow high simply adds another non-confirmation to the ominous seven-month series of divergences between the Dow and the advance-decline ratio. Third, the upside confirmation of October 10 occurred in a market that was already heavily overbought.

I want to go over the price/breadth divergence picture again, as it has now gone on so long that I feel the situation is now critical. As detailed in the last Letter, the A-D ratio (which tracks the advancing or declining tendencies of the majority of stocks on NYSE) recorded its 1988 high on March 17. Since then the A-D has traced out a series of declining tops with a lower A-D peak on April 12, a second lower peak on July 5 and a still lower peak on October 10 (see page 2 chart).

The crucial question here is "What does this extended period of price/breadth divergence mean, and what can we expect in the period ahead?" History may provide the answer. For that reason it should be instructive to study previous examples of extended (four months or more) price/breadth divergence. The following are instances which have occurred over the past 30 years.

(1) A major price/breadth divergence took place during March to early-August 1959. During that five-month period the Dow advanced while the A-D declined steadily. The general market (as measured by the A-D ratio) sold off sharply during August and September, then rallied again. On the rally the Dow surged to a new high of 685.47 (January 5, 1960) although the A-D remained flat. In the face of this final, flagrant price/breadth divergence, the Dow sold off sharply, sinking to 577 by October 1960. At the same time, the general market caved in, suffering far worse than the Dow.

(2) During January to May of 1969 the Dow pushed higher while the A-D recorded three lower tops. On May 14, 1969 the Dow reached a high of 969.45, but the four months of breadth/price divergence proved too much for the market. Stocks turned down in May with the A-D ratio collapsing. By May of 1970 the Dow had sunk to a low of 631.16.

(3) From March though August of 1972 the Dow worked higher while the A-D declined persistently. In November the Dow surged to a high of 1036.27 while the A-D produced a half-hearted advance resulting in another non-confirmation. A final rally, and the Dow hit a record high of 1051.70 on January 11, 1973 (I remember it well) with the A-D again refusing to confirm. From there Wall Street suffered its worst bear market since the 1930s. On December 6, 1974, the Dow hit a final low of 577.60 .

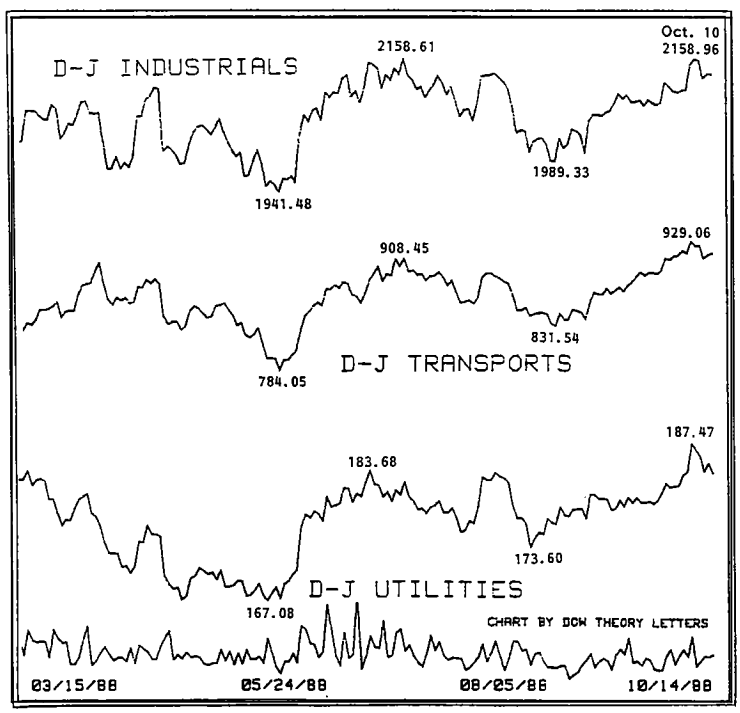
(4) An extended seven-month price/breadth divergence occurred during the period of September 1980 (Dow 975) to April 1981 (Dow 1024). The general market started down in late-April and by September the Dow had faded to 824. The long decline carried into 1982 with the Dow hitting a final low of 776.92 in August of that year.

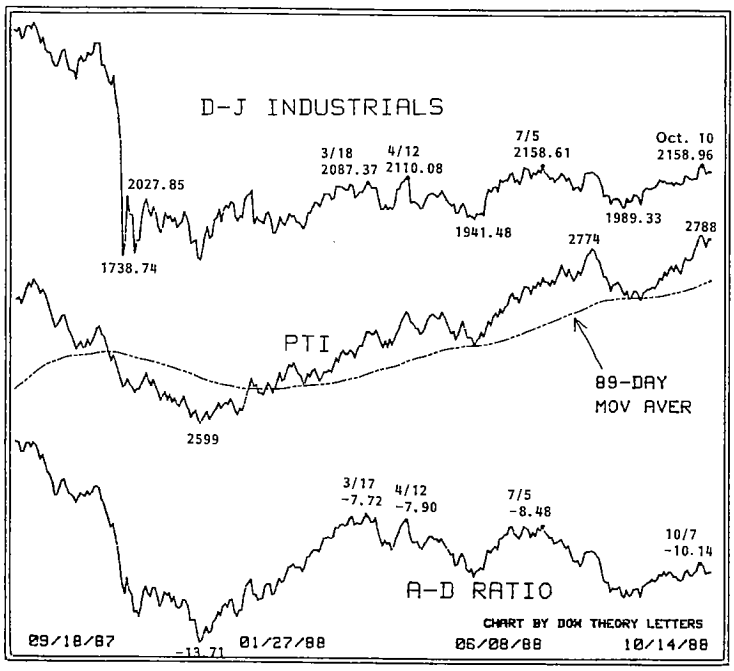
So the history of extended periods of divergence between the Dow and the A-D ratio is not a happy one. Periods of price/breadth divergence are invariably deceptive and confusing, but the final result always seems to be a major decline in the Dow with the majority of stocks (as measured by the A-D ratio) suffering accompanying severe declines.

Conclusion: The price/breadth divergence that began on March 17, 1988 has (as of October 10) lasted seven months and therefore must be listed as one of the longest periods of divergence in stock market annals. From my own studies I have concluded that the longer (in duration) the price/breadth divergence, the more dangerous the technical situation.

Question: Could the Columbus Day new high on the Dow have marked the end of the 1987-88 post crash recovery?

Answer: Yes, it could have. The kind of extended price/breath divergence we have seen in '88 is fairly rare and has signaled the





end of many previous advances. Furthermore, the most recent Dow rally represents the fourth attempt by the Dow to push into and then above the 2100 area. Edson Gould's "rule" runs as follows: "The market often tries three times to penetrate an important resistance level. On the fourth try, it will either make it big -- or fail big."

Another factor must be considered here. As I've said so many times, values are constantly diminishing during a bear market. The recovery since the crash has lasted a year, and thus I feel the bear market is "behind schedule." When that happens, the market will often make up for lost time.

Question: Everybody says we can't have another crash. Do you agree?

Answer: Crashes are extremely rare, and therefore the odds are always against such action occurring. Furthermore (except for psychological considerations), it doesn't really matter. This bear market is going to run to conclusion, and how it gets there isn't the important point. The important point is for investors to be out of the way as the bear market develops.

As to the possibility of "another crash," it's well to remember that the market can do anything. I count eight periods during 1930-32 in which the market descended so violently that each sell-off must be considered a crash on its own. The market crashed in November 1937, and it crashed again (four months later) in March 1938. So bear markets can produce one or more crashes or none at all.

INVESTMENT POSITION: The bear is still king of the box. We are out of stocks and have been since mid-1987. Bonds (which I've consistently recommended) have been winners, but the bond surge of the past few weeks smacks of too much enthusiasm. So I've stopped buying bonds, at least temporarily. Merrill Lynch, in full page ads (a bit belatedly), is telling the world that bonds are a great buy. Can Merrill and Russell both agree and both be right? Sure, why not? Besides, everybody and his brother is into contrary opinion these days, and I'm afraid they're overdoing it.

DOW'S THEORY: A widely-circulated advisory service starts its September 22 report as follows: "We can't keep silent any longer on a matter we think is overdue for comment. The Dow Theory seems to us to be shouting that we are in a bull market. The self-appointed Dow Theory experts refuse to discuss this . . . ."

I don't consider myself a "self-appointed Dow Theory expert," but I am certainly willing to discuss the Dow Theory, so here goes.

* * *

Wall Street is the financial and money center of the nation. Billions of dollars exchange every day on the Street. The electronic age has taken over the Street. If you buy or sell a stock or bond, within a matter of seconds that transaction will run through the computers of Wall Street. Yet strangely, I don't know any area of human activity which operates in such ignorance of its own basic fundamentals as does Wall Street.

I've never counted the number of books I've read about the stock market. As a rough guess I'd say I've read 200 books and perhaps 1,000 separate articles or treatises. Of that number, I'd probably list 95% as having proved useless or not worth the time reading.

I've spent two-thirds of my life studying and writing about the markets. And I'd say that without a shadow of a doubt the materials that have served me best are the books and papers written by the great Dow Theorists -- Charles H. Dow, William P. Hamilton, Robert Rhea, and E. George Schaefer.

First, let's talk a bit about Mr. Dow, a man who, by any reckoning, must be considered a brilliant market observer and theoretician. Charles Dow started his business career as an investigative reporter specializing in business and finance. In 1885 (and few people are aware of this), Dow became a member of the NYSE, and this provided him with intimate knowledge of how the markets work. In 1889 this remarkable man began publishing a little newspaper which he called the *Wall Street Journal*. Between 1899 and 1902 Dow wrote a series of editorials for his *Journal*, editorials that many (and I am one of them) consider among the finest writing ever to come out of Wall Street. Written 90 years ago, these editorials are as pertinent and valuable today as they were the day they were penned.

Dow was a modest man, and although many admirers begged him to write a book on his theories, Dow stubbornly refused. Dow died in 1903. However, Dow's good friend, S.A. Nelson, published 15 of Dow's *WSJ* editorials in a little volume entitled "*The ABC of Stock Speculation.*" A footnote at the bottom of each of the chapters refers to the editorial as "Dow's Theory." However, Dow himself never used the term Dow Theory.

Dow was fascinated with stock trends, and he wrote that "*the market is not like a balloon plunging hither and thither in the wind.*" Dow insisted that the market moved in broad trends (a thesis accepted by few at the time). To prove his trend theory, Dow constructed a stock average which first appeared in his "Customer's Afternoon Letter" on July 3, 1894. This original average (made up of 11 rail stocks) was revised many times over the course of Dow's life and afterwards. The first all-industrial stock average (12 stocks) was published by Dow on May 26, 1896.

Following Dow's death two other men took over as editor of the *Journal* for brief periods. William Peter Hamilton was the fourth editor of the *Wall Street Journal*. Hamilton wrote a brilliant series of 252 editorials. These editorials appeared in the *WSJ* during 1903 to 1929 and also in *Barron's* during 1922 to 1929. As time went on Hamilton's writings attracted a wide and devoted following. In 1926 Hamilton wrote his landmark book entitled "*The Stock Market Barometer*" in which he presented his version of the Dow Theory.

Hamilton had been Dow's understudy at the *Journal*, and in his book Hamilton presented much of Dow's market observations and philosophy. But Hamilton also included his own views on Dow Theory, and it was Hamilton who first defined the principle of confirmation in the Averages. Hamilton died in 1930, soon after writing his most famous editorial "The Turn of the Tide" (written

on October 25, 1929). This fateful forecast served as the obituary for the fabulous 1921-29 bull market.

The next great writer in the Dow Theory chain was Robert Rhea. Rhea was a devoted student of Hamilton's, and Rhea adhered closely to Hamilton's version of Dow Theory. Over a period of many years Rhea codified and refined the Dow Theory, always deferring to Hamilton in his explanations. In my opinion Rhea was one of the greatest stock market traders of all times.

Rhea had a marvelous, almost uncanny, gift for reading the Averages. Rhea possessed an ability (few have it) to identify and trade on the secondary as well as the primary market turns. Rhea was bed-ridden with tuberculosis, and he relied on his extraordinary stock-trading ability to support himself and to pay his large medical bills.

On November 12, 1932 Rhea started a stock market service which he called *"Dow Theory Comment"*. The service was successful from the start. Rhea called the exact bottom of the bear market on July 8, 1932, a feat that I consider one of the most remarkable in the history of stock market analysis. Rhea's early bullish letters were written during the depths of the greatest depression in American history, and you can imagine the skepticism with which those bullish reports were greeted. Rhea also called the turn (to the downside) in the bear market of 1937, and this, even more than his 1932 bull market call, made Rhea a household name on Wall Street.

Sadly, Rhea's disease took its toll. Seven years after he began his advisory service he died (1939). Following Rhea's death the Dow Theory lay dormant for many years during WW II and afterwards.

The next major figure in Dow Theory history is a man from Indianapolis, E. George Schaefer. Schaefer started his career as a stockbroker with Goodbody & Co. He spent many years studying the writings of the great Dow Theorists who preceded him. But Schaefer concentrated his studies on the brilliant and seminal writings of Charles H. Dow. Schaefer was a firm believer in values, and he often quoted Dow on this subject. One of Schaefer's favorite Dow quotes was: *"An investor who will study values and market conditions, and then exercise enough patience for six men will be likely to make money in stocks."*

Another Dow quote used by Schaefer states: *"It is always safe to assume that values determine prices in the long run. Values have nothing to do with current fluctuations. A worthless stock can go up 5 points just as easily as the best, but as a result of continuous fluctuations the good stock will gradually work up to its investment value."*

Schaefer believed that both Hamilton and Rhea placed too much attention on the pattern of the Averages and not enough emphasis on the principle of buying great values and holding those values throughout the life of a bull market. Schaefer wrote that *"It has always been of interest to me that Hamilton and Rhea . . . both steered away from Charles H. Dow's thinking in many respects. Hamilton was very reluctant to give Dow the full credit he deserved. And Robert Rhea in turn, disregarded the work of Dow almost entirely and specialized in trying to improve the Hamilton version of Dow's Theory."*

In 1948 Schaefer started his own advisory service which he called *"Schaefer's Dow Theory Trader."* Schaefer's timing was fortunate. On June 13, 1949, with the Dow at a multi-year low of 161.60, one of history's great bull markets began. Exactly five days from that low, on June 18, 1949, Schaefer wrote what I consider an advisory masterpiece (I still have that report). In that report Schaefer stated his reasons for believing that a great buying area was at hand and that a major bull market had begun.

In his June 18, 1949 report Schaefer writes: *"The philosophy of Charles Dow always gave first consideration to values, then to economic conditions and third to the action of both the Industrial and Rail Averages. When the low point of a bear market is reached, values will be the first indication of a change in trend. In the past 17 years only three opportunities have presented themselves to buy stocks at great values. Now the fourth opportunity is making its appearance."*

Schaefer's June 1949 forecast turned out to be amazingly accurate. The Dow turned up from its 161.60 low point, and a great bull market began. On February 9, 1966, 17 years later, the Dow topped out at 995.15. Those who followed Schaefer's Dow Theory interpretations and investment procedures (i.e., investors who held their stocks throughout the bull market, as Schaefer repeatedly advised) made fortunes.

One of the reasons Scaefer started his advisory service was to present what he termed his "New Dow Theory," a set of principles which he insisted "could be applied profitably to present-day markets." Schaefer wrote in 1960, *"A study of the averages themselves can be highly rewarding. But in my opinion a forecast based on past movements of the averages cannot be conclusive. Predictions of events to come are more reliable if they can be reinforced by analysis of other technical and more conclusive factors."*

What were these "other factors" which Schaefer referred to? Some of these were values (and I emphasize values), the 200-day moving average of the Dow, the short-interest ratio, the advances and declines, Dow's 50% Principle, market sentiment, market phases, and the yield cycle. Remember, prior to Schaefer, orthodox Dow Theorists tended to avoid all "extraneous" items other than the pattern of the averages and volume, claiming that they only interfered with basic Dow Theory studies. Schaefer disagreed vehemently.

Schaefer possessed great market intuition, and he used his market instincts plus his newer tools to ride the great 1949-66 bull market all the way from the bottom in 1949 to the top in 1966. Through reactions, corrections, panics and dips, Schaefer insisted that his subscribers hold their shares and buy more on all periods of weakness.

That may sound easy, but believe me it is not. The number of people who hold stocks from the beginning to the end of a bull market can probably be counted in the dozens. In 1966 Schaefer turned bearish on the market (based on third phase considerations and overvaluation of stocks), and he advised his followers to "sell out." Schaefer remained bearish until the time of his tragic death (by suicide) in 1974.

Although Hamilton and Rhea took careful note of the secondary reactions in bull and bear markets, Schaefer advised ignoring these "temporary reactions" and staying with the primary trend of the market. In his historic report of June 18, 1949, Schaefer wrote, *"Once stocks are purchased both the minor and secondary movements in the markets should be completely disregarded. A new period of prosperity will follow, once the present recession has run its full course."* We now know how prophetic those words (which were written during a time of extreme fear and gloom) were.

Later Schaefer wrote, *"So far as I can ascertain from his original writings, Dow had an open mind, and there was a great deal of flexibility in his thinking regarding the price movements."*

The following is extremely important, and subscribers should take careful note of this. Schaefer believed that mass emotions were changing the character of the market. He realized that Wall Street was maturing, that the Street was gathering a much larger following, and that the American public was becoming much more involved with investments (today, of course, Wall Street has gone both electronic and global). This relatively new phenomenon of mass emotions, Schaefer believed, had to be taken into consideration as far as the Dow Theory was concerned.

Wrote Schaefer, *"My new Dow Theory involves a broad, balanced manner of thinking about the market and your own emotions. It is a far cry from the narrow 'system' that places a complete reliance upon what the averages do. Yes, we who study the new Dow Theory watch the averages. But along with any such observations*

we realize and understand that the market is composed of people of all types, and that all people are born emotional."

So what was the result of Schaefer's emphasis on the emotions of an enormous and growing investing public? It was this -- Schaefer allowed for secondary reactions to far overshoot the restrictions which were laid out by orthodox Dow Theory. Years earlier Rhea had written that in a bull market, secondary reactions tended to retrace one-third to two-thirds of the preceding uncorrected primary advance while tending to last three weeks to three months.

Schaefer dismissed Rhea's "out-dated concepts." Schaefer believed that mass psychology and the emotions of the crowd could take the averages beyond the "normal bounds" outlined by Hamilton and Rhea. Wrote Schaefer, *"Today our new Dow Theory allows the crowd to get as emotional in its selling or buying as it will -- with no restrictions whatever upon the duration or extent of the secondary or intermediate trend. In primary bull markets, when things get scary, we simply wait for the fearful to sell out, and then we assume that the main primary trend will resume as expected. In primary bear markets just the opposite holds true."*

This "new Dow Theory" thinking proved extremely valuable in late-1957 when a severe secondary suddenly hit Wall Street. When the Averages broke through their preceding secondary lows, many orthodox Dow Theorists who relied almost totally (as most do today) on the pattern of the averages, proclaimed that a "bear market had started." Of course, these bears ignored such critical factors as the phases, length of the bull market, values, Dow yield, etc.

Schaefer differed totally (as I did at the time) with the prevailing bearish Wall Street opinion. Both of us inisisted that the bull market had not yet experienced a classic third phase and that the late-1957 cave-in was not a bear market but a severe secondary reaction which had been intensified by the extraordinary public fear -- fear which had been triggered by the violent breakdown in the Averages.

In fact, I was so certain during 1957-58 that we were witnessing a bull market correction rather than a primary bear market that I started *Dow Theory Letters* at that time. Furthermore, in December 1958 I wrote my first article for *Barron's* (entitled "Dow Theory Revisited"). In that article I presented my reasons for believing that the primary trend was still bullish, and that a great, speculative bull market advance lay ahead. That *Barron's* article drew a tremendous response and was instrumental in putting me in business (in the years that followed I wrote about 25 additional articles for *Barron's*).

Basic to both Schaefer's and my thinking during 1957-58 was the fact that not only had there been no bull market third phase but that on the drastic 1957 decline the 50% Principle remained bullish.

Let me explain because this is important. The Dow had risen from a 1953 low of 255.49 to a record high in 1956 of 521.05. The halfway or 50% level of that three-year rise was 388.27. On the drastic1957 decline the Dow collapsed to a low of 419.79, a level which was nevertheless well above the 388.27 or 50% level of its preceding rise. The fact that on the decline the Dow could retain better than half the gains of the 1953-56 rise was a powerful bull argument, particularly since this phenomenon occurred in the face of such universal, black pessimism (by the way, I have never, before or since, seen pessimism to match that which existed during the 1957-58 recession and market collapse).

The stock market action of 1957 under the 50% Principle, by the way, was in stark contrast to that which occurred last year in October 1987. Let's examine the two periods.

First, the market during 1987 had exhibited all the characteristics associated with a bull market's third phase top. These characteristics included overvaluation in stocks, record thin stock yields, widespread public participation, great expectations for a higher market (remember "Dow 3600"), high volume, and spectacular rises in low-priced stocks. Last but not least, the Dow advance had assumed the dangerous pattern of a giant, ascending, parabolic curve.

The third (speculative) phase of the 1974-87 bull market began at the 1984 low of Dow 1086.57. The ensuing rise carried to the 1987 high of Dow 2722.42. The halfway or 50% level of the 1984-87 rise was 1904.50. At the crash low the halfway level was shattered. The Dow on October 19 closed at 1738.76. This was far below the halfway (or 50%) level of 1904.50.

Back to George Schaefer: Schaefer used the 200-day moving average of the Dow to advantage in his work. But he warned *"that as with other technical studies the 200-day moving average should never be considered alone. My experience has been that interpretations under the 200-day moving average must always be correlated with other studies."*

Much has been made recently of the upturn in the 200-day moving average. In fact, many optimists here in 1988 are proclaiming that the direction of the 200-day moving average identifies the direction of the primary trend of the market. Since the MA is now rising, state these analysts, "Presto, we must be in a bull market."

The experience during the 1949-66 bull market again serves us well. The 200-day MA turned down in 1953 (during a secondary correction), and it turned down again in 1956 (during another secondary correction). Neither of these downturns in the MA indicated that the primary trend had turned bearish, and each of the downturns in the MA was followed by a major rise as the bull market reasserted itself. Thus, those who say that the direction of the 200-day moving average identifies the direction of the primary trend of the market would do well to study history. As Schaefer said, the 200-day MA should not be used alone and to do so can be downright deceptive.

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I wrote the foregoing section because I wanted to give subscribers an accurate (even though brief) view of the Dow Theory and its evolution over the past 90 years. Few, very few, market practitioners have ever made a serious study of Dow's Theory although many mouth meaningless Dow Theory platitudes. The Theory remains the basis for all technical analysis and also the basis for much intelligent and profitable investing. I have shown how the Theory has evolved and been improved as each Dow Theorist since Charles H. Dow has worked with the Theory and applied it to the stock market.

At the end of his book (written in 1960) Schaefer states, *"It is my hope that the foregoing chapters will inspire analysts, brokers and market researchers to improve existing methods to aid investors in building profits in stocks and to develop new ones. . . . Any investor, analyst or broker or market student who wants to improve his chances for success in the stock market could do so through a study of the factors which influence the market's price movement, a study of investment procedures, and a study of mass psychology, including his own psychology."*

I have attempted to carry on with the work of Dow, Rhea, Hamilton, and Schaefer. I believe that the stock market today is more difficult than ever before, mainly because so many analysts, professionals, money managers and serious individuals are involved and competing for investment profits (and increasingly for short-term profits). Furthermore, the entrance on the Wall Street scene of the various options and futures plus computerized trading make the market game faster, bigger, more hazardous -- and far more deceptive.

In my constant search for tools with which to follow the market and identify its trends, I have developed two important aids -- my Primary Trend Index and DowPow. Because widespread knowledge and use of an indicator tends to render an indicator ineffective or even useless, I have not divulged my method of tabulating either DowPow or the PTI (I will some day, at least to a limited audience).

The PTI and DowPow are but two additions to the growing list of instruments that have been used or added to the basic Dow Theory

armory. In the end, however, the "hidden ingredient" for market success is the practitioner's own instinct or intuition. Market analysis, as so many have observed, is an art, not a science. What works one time may not work the next time (particularly if the successful device gathers too wide a following).

The market doesn't want too many geniuses guessing at its intentions. And Wall Street has its own method of getting rid of the tools that "work." The method is simple. Wall Street discounts and then renders such tools useless.

But that's exactly why Dow Theory has lasted for nearly a century. It has lasted because it is not a mechanical method or device, and it is not infallible. Dow Theory requires **interpretation** and it require **constant study**. Few, it seems, are able to interpret Dow's Theory correctly. But even fewer are willing to do the basic background work.

Nobody is a genius or a guru where the market is concerned. Every Dow Theorist, great or not, has made his ghastly mistakes. Maybe when I am 80 or 90 I will know enough to avoid most of the mistakes. But by that time perhaps some new student will have taken over, and he will be ready to make his own predictions as well as his own errors.

So far, I have not seen anyone who I believe has the feel, the intuition, the interest or the talent to take over the Dow Theory. But as sure as night follows day, someone will come along. In the meantime, I will continue to do my best. In the future I'll makes mistakes, and (hopefully) I'll also make some good calls. But count on this -- I will always be fascinated with the markets and I will alway do my best. In 40 years of studying the price movements I have never, for a single day, been bored.

Question: Russell, why do you keep emphasizing the market's 1987 action? This is almost 1989, and the past is dead, it's ancient history.

Answer: I emphasize the '87 action because that was the action and the pattern and the psychological phase that IDENTIFIED THE TOP of the bull market. Once you've passed the top, the next move is the path toward the ultimate bottom.

Here again we come to the thesis that so few people can accept -- the thesis of inevitability. The inevitability thesis tells us that once a bull market records its top and dies, the bear takes over and come hell or high water the bear market will run to conclusion. If we passed the top last year (which I'm convinced we did) then we are now on the path toward the next bear market bottom. The only question is how, in what winding, deceptive, hair-pulling, tedious manner, do we get to the bottom? And how long will it take?

Charles Dow recognized the stubborn refusal by mankind to recognize the change from bull market conditions to bear market conditions -- and then from bear back to bull conditions. So I might well end this section with a quote from Dow: *"There is always a disposition in people's minds to think that existing conditions will be permanent. While the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this which make it unlike its predecessors and give assurance of permanancy."* Charles H. Dow, June 8, 1901.)

NOTES and QUOTES: Graduates: Last year the US graduated 540 doctorates in computer sciences, which was 460 short of the 1,000 needed to fill current demand, and half of those degrees went to foreign students. Over the last 10 years six out of every 1,000 US students earned engineering degrees. In Japan, 43 out of every 1,000 earned engineering degrees.

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There are all kinds of "solutions" being offered to cure America's deficits. Mike Dukakis (Du-taxes) wants to double the size of the IRS. Ravi Batra wants to slap a wealth tax of 2% on all individuals with assets of over $1 million with the tax rising to 7% on those with assests over $6 million. Stated Batra, "The tax I'm talking about is on, say Ross Perot who has $3.5 billion. He can afford it." Russell comment: Don't you love people who talk about taxing other people and deciding that "they can afford it"?

* *

Speaking of Perot, here's his formula for solving the deficits: Let Europe and Japan pay for their own defenses. Cut out Social Security benefits for those who don't need it. But gee, Ross, if we cut out SS benefits for those who don't need it, what about all the money those people put in during all those years. Don't they get anything back? No, well, then let's call SS for what it really is -- ONE BIG TAX.

* *

What do you think of the "new" *Wall Street Journal* and its three sections instead of two? Down in New Orleans last week Bob Prechter, Stan Weinstein and I all asked each other that question. Our answer: "We hate it!" We think the new Journal is a mess, hard to read, a pain to handle, and the news and statistics are not the ones we want. And where are the charts we want? The *Journal* claims it spent a year asking people for suggestions about improving the paper. We're wondering who the hell they asked.

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The foreign exchange market "forex" is big, and I mean BIG. For example, last October 19 the stock market crash volume on the NYSE hit a record 604 million on transactions which were figured at $21 billion. That's a lot of bucks, but forex trades $300 billion daily. London accounts for one-third of this total, NY for about $50 billion and Tokyo about the same. It's a 24-hour around-the-clock market -- on Saturday the traders call Bahrain, the only open market. Forex has been a gift to the big banks who are groaning under foreign debt losses. The eight biggest US banks made $2 billion in profits on forex trading. Salaries for top forex traders run from $200,000 to $1 million but most traders are "burned out" before age 35.

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The US government's assault on our income continues unabated. From James Lebhetz's colulmn in *MG Financial Weekly:* "Sometime in 1989, according to my sources, Treasury will propose a limit on all income not subject to alternate minimum tax (essential purpose) from issues dated after a specific 1989 date. A number between $25,000 and $40,000 is being suggested as the maximum amount of tax-exempt income to be allowed on any tax return. Any amounts above the selected limit will be treated as taxable income. All income from bonds issued prior to the selected 1989 date will be exempt from taxation." If true, can you imagine the premium that "old" long-dated munis will sell for?

* *

Throughout history from the Egypt of the Pharoahs to ancient Rome to Spain to Holland to France to Britain to the US you can trace the path of economic power through a nation's ability to accumulate gold or its inability to hold on to its gold. Along these lines it is worth noting that Japan's holdings of gold at the end of World War II were virtually non-existent. Gold imports for the first seven months of 1988 totaled 166 tons, and for the full year Japan is expected to import 300 tons. In the next 10 years Japan is expected to reach 3,000 tons.

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The 21st century will belong to Japan, says Daniel Burstein in his new book entitled, "The Japanese Financial Empire and its Threat to America." Burstein says that no nation can expand as Japan has without the means of protecting itself. Thus, Burstein sees Japan becoming a major military power within 10 years. Americans, he says, don't take the obvious shift in power seriously. The period ahead is going to be ruthlessly competitive. The new relationship can be friendly, but the two forces at work are our blindness and Japan's exploitation of it. The Japanese are increasingly thinking of themselves as No. 1, even though they complain of their disadvantages and their lack of raw materials and land.

Burstein says that many Japanese laugh to our faces, while some Japanese leaders have asked him, "How can you let your big companies be sold off to us? You should be ashamed." Says Burstein, the CEO of a major Japanese company would commit

suicide if he allowed his company to be taken over by foreign interests.

Burstein says that even if all the barriers were to fall, US business hasn't the wisdom to move into Japan the way they have moved into the US markets. At this point we require Japanese investments at almost every level of our economy. The choice is to accept this or close the doors. Burstein favors acceptance. We should be battling the Japanese economically, but we're passively letting them take over our markets. Worse, we've ceased to be financially independent because the Japanese are financing our government operations. Worst of all, we have a powerful set of thinkers running the nation who believe that absolutely nothing is wrong and argue that our situation is better than ever. It's quite a book -- and the picture Burstein paints is scary.

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Steve Hartman (Finance Director of Babylon, NY) in a Letter to the *WSJ* (Sept. 21) states that "very conservative assumptions of the national debt compounding at an annual rate of 8.5% interest with an annual $160 billion deficit show that by the year 1992 the national debt in constant 1986 dollars will surpass the gross national product by $200 million. Whereas in 1986 the national debt stood at 54% of GNP, by 1992, when the next presidential race occurs, the national debt will be 104% of GNP. This represents a doubling of the national debt in comparison with GNP is just six years. Interest costs will increase from 17.35% of the national budget in 1986 to 30.36% in 1992. . . . As the debt continues to exceed the GNP, capital continues to be diverted from the productive capacity of the economy. This mushrooming debt spiral ends in a total loss of confidence in the nation, resulting in bankruptcy, currency devaluation, inflation or some withering combination."

Russell comment: The foregoing could well be what the bear market is all about, and it could explain why Wall Street is steeped in a bear market even while the business news is still rosy.

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I thought this quote from Henry Kaufman's article ("Memo to the Next President") in the Oct. 9 *New York Times* was extremely important:

> For the first time since the end of World War II, if the economy stalls, the Government will not be able to spend itself out of a recession since the budget deficit is already at an insupportable magnitude. This is the unfortunate legacy of the budgetary malpractices in this decade.
>
> In a situation that leaves little room for maneuvering, there is a possible escape hatch: coordination between the United States and its major trading partners.
>
> The first thing that would need to be done during the early phase of a business recession would be to lower interest rates sharply, and the Federal Reserve could only do that, *and* produce the desired market effects, if the United States had the complete cooperation of our allies. With world economies so inextricably intertwined, if interest rates were lowered unilaterally, what the United States would do is create turmoil in the foreign-exchange markets; investors would stampede by selling United States Treasury bonds, which would force interest rates even higher and thus worsen the recession.

GOLD: I first started writing about gold in my Letter of August 15, 1960. I've written about gold in each and every Letter since . So it's twenty-eight years of writing about gold -- that's got to be some kind of a record. In 1970 you could by American Gold Eagle coins at $65 a piece (and I was buying them). By early-1980 you could sell those coins for near $1000 (I sold out too early -- at around $700, but obviously no regrets).

Over the last few years I've again been advising subscribers to buy bullion gold coins on the basis of a monthly, fixed dollar-amount. In other words, you buy $500 or $1000 or any dollar amount of gold coins you want -- each month, without fail.

Now about dollar averaging -- ordinarily I don't advise it. There's a danger in dollar averaging, and the danger is this: the item you're busily accumulating may go bankrupt.

Let's say you like a certain stock, Designers and Developers, Inc. (symbol DEAD), and you want to accumulate the stock. You buy 500 shares of DEAD each month, and pretty soon you have 10,000 shares. But DEAD (which you own at an average price of 20) is now down to 16. Then the rumors come out -- "DEAD is in trouble, the treasurer closed down the bank accounts and ran off with all the assets." A week later DEAD is at 6 and the boys on the Street are talking "belly up." You're trying to unload the stock, and then (gulp) your broker calls and says, "Charlie, I don't know how to tell you this but there are no bids for DEAD." So that's the danger of dollar averaging -- particularly in a down market. The danger, in a word, is bankruptcy. The danger is that the item you've been accumulating might end up at zero.

That, however, is not a problem with gold. Gold is money, and unlike dollars, or pounds or yen, there is no debt against gold. In other words, gold may fluctuate in terms of paper currencies, but there is no way in the world gold can go bankrupt. And that's why I have no qualms about advising my subscribers to accumulate gold coins. When it comes to insurance against a bear market catastrophe -- a collapsing dollar, runaway deficits, a failing banking system, a panic in the stock market, a surge in inflation, another war -- there is nothing as comforting as those gold coins in your actual possession.

From the technical view, I pointed out in the last Letter that gold had formed an "inverse parabolic curve pattern," a pattern which often identifies the end of a decline. Since then gold has climbed to the 410 area, and I think there's a good chance that the 393 area represented the bottom for gold.

Also, an interesting non-confirmation exists between gold and the XAU gold/silver average (you can punch out this average on most brokerage machines). The recent break in gold took gold well below its February low of 430. On the recent weakness, however, XAU held above its own February 3 low of 84.71. In fact, the lowest XAU has been in recent months is the September 19 low of 87.97. XAU is now above 90. Thus, the metal stocks did not confirm the metal itself -- often an indication of an important turn.

But as I've said before, I don't care where gold goes now. I want to accumulate it, and if it rallies that simply means that I'm going to get less gold for my dollars.

LATE NOTES: Every financial publication in the nation has done "an anniversery of the crash" issue, with an accompanying story about how the crash was "a terrible accident, but it can never happen again, now that we understand why it occurred in the first place."

And who knows, maybe that was the only crash we'll see in this bear market. But make no mistake about it, this bear market is going to run to its conclusion -- be it with crashes, a series of extended declines, erratic downside-dribbles or what have you.

Most recently the Average rallied to new recovery highs, Transports to 929.06. on October 7, Industrials to 2158.96 on October 10 (see page 1 chart). On October 7 my PTI pushed to a new recovery high of 2786. My guess is that the PTI will prove to be a coincident indicator here, turning down with the market rather than ahead of it.

However, two items give the lie to the "happy picture" presented by the Averages. (1) First, DowPow continues to go nowhere, having moved sideways ever since the crash. (2) Second, the breadth/price divergence continues, with the latest rise in the A-D ratio (see page 2 chart) being the weakest of any this the year. Judging by the ominous look of the price/breadth situation, I'd say that Wall Street will be lucky if it can hold off trouble until after the election.

NEXT MAILING: Nov. 12